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ALTERNATIVE MINIMUM TAX IMPACT AS ASSETS ARE LIQUIDATED

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The agricultural community has yet to emerge from its state of recession. The USDA has found that some 98,000 farms are technically insolvent and that as many as 417,000 are experiencing financial stress so severe that they will require some form of debt or asset restructuring to survive. Studies indicate that at least 30% of the farms nationwide have debt to asset ratios in excess of 40%, the level cited as the indicator of financial stress. [1]

The financial stress farmers are currently experiencing is also being felt throughout other sectors of the economy. The most immediate impact of the current crisis is upon those who have extended credit to farmers. Studies indicate that under the most likely scenario, as much as 50% of all agricultural debts cannot be fully serviced. For this to happen at current rates of return, 34% of the agricultural debt would have to be liquidated and about 5% would have to be written off entirely. [2]

In addition, the dramatic decline in land values has affected the net worth of all farmers. According to one study, even if farmers are able to maintain current income levels, about 10% or more of farm assets will have to be sold for farmers to service their debts. [3] Should income and asset values decline further, the percentage of farm assets required to be liquidated

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[1]Source: Economic Indicators, State Income and Balance Sheet Statistics, USDA 1983.
[2]Food and Agricultural Policy Research Institute study
[3]FAPRI

could increase to as high as 25% or more in some regions of the country.

Liquidating assets may sound like the simple solution to reducing heavy debt load while not impairing a farm's already tight cash flow. However, the liquidation of capital assets can trigger the imposition of the federal alternative minimum tax. [4] All individuals, trusts, estates and other non-corporate taxpayers are subject to the alternative minimum tax on a list of deductions and tax favored items known as tax preferences. This tax is in lieu of the "regular" tax if it is greater.

Often, liquidation is voluntary and can be either partial or complete. However, the alternative minimum tax is also triggered upon the forced liquidation of assets. Assets liquidated at a forced sale outside of bankruptcy can result in capital gains to the taxpayer which, in turn results in alternative minimum tax liability. This can include a deed transfer in lieu of foreclosure. For example, the exchange of realty with a basis of $20,000 and a fair market value of $100,000 for a mortgage deed valued at $100,000 results in $80,000 of capital gain. This capital gain must be included as a tax preference item when computing the alternative minimum tax. Also, when assets are abandoned from bankruptcy and involuntarily liquidated, the gain results in alternative minimum tax that must be paid by the individual and not the bankruptcy estate.

For many farmers, accelerated depreciation methods have reduced machinery and building book values well below current market value. This was beneficial in that it stimulated investment in modern facilities and reduced the tax burden of the farmer during periods of prosperity. Selling these items now results in large gains to the farmer that are subject to taxation.

In addition, land with a low original basis or breeding stock with a zero basis often is sold at a fair market value much higher than that basis. The sale of any such capital asset results in either capital gain or loss. [5] The amount of recaptured depreciation is treated as ordinary income, but the rest of

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[4] I.R.C. Sec. 55 et seq

[5] I.R.C Sec. 1221 defines a capital asset as any property held by the taxpayer except his stock in trade, property held primarily for sale to customers, depreciable property used in a trade or business, real property used in a trade or business, or copyrights. I.R.C. Sec. 1231 states that gains from the sale of assets used in a trade or business held for more than six months shall be treated as an exchange of a capital asset.

the gain, and all of the gain on non-depreciable property, is given capital gains treatment which is then subject to the alternative minimum tax. 6

The alternative minimum tax is imposed on a person's alternative minimum taxable income. For a taxpayer filing a joint return, the first $40,000 of alternative taxable income is exempt from the alternative minimum tax. 7 Any alternative minimum taxable income in excess of the exemption is taxed at a rate of 20%. If this amount exceeds the regular tax, the excess is imposed in addition to the regular tax.

It is important to note that the alternative minimum tax is imposed only to the extent that it exceeds the regular income tax. For purposes of the alternative minimum tax, the regular tax means all taxes imposed by Chapter One of the Internal Revenue Code, minus all non-refundable credits and certain other punitive taxes. 8 The alternative minimum tax may be reduced by the foreign tax credit and certain refundable credits. However, all non-refundable credits other than the foreign tax credit cannot be used to offset the alternative minimum tax.

COMPUTING ALTERNATIVE MINIMUM TAX

In determining the alternative minimum taxable income, adjusted gross income is reduced by the sum of the alternative tax itemized deductions and the alternative tax net operating loss. The alternative tax itemized deductions include casualty and gambling losses, charitable contributions, estate taxes on income with respect to a decedent, qualified housing interest, and other interest to the extent of the taxpayers qualified net investment income. 9 Qualified charitable contributions that exceed the 50% ceiling may be carried over to the extent of the excess to offset future years regular tax.

A qualified housing interest means interest which is paid on indebtedness incurred during the year to acquire or remodel an property that is used as either the taxpayers principal residence or is a qualified dwelling used by the taxpayer or any member of the family on more than a transient basis. 10 Any interest

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[6]I.R.C. Sec. 1245 and 1250

[7]$20,000 for married individuals filing singly
$30,000 for unmarried individuals
I.R.C. Sec. 55
[8]I.R.C. Sec. 55(b)(2)
[9]I.R.C. Sec. 57(b)
[10]I.R.C. Sec. 55(e)(4)

allowed as a deduction for interest, other than the qualified housing interest already excluded, may also be used to reduce the alternative minimum taxable income to the extent that it does not exceed the taxpayers' qualified net investment income. Interest on second homes and recreational homes is fully deductible. Interest on cars and boats and the like is deductible up to the amount of the qualified net investment income.

Qualified net investment income is the ceiling for the amount of interest that may be deducted from the determination of alternative minimum taxable income. It is limited to the excess of qualified investment income over qualified investment expense. In computing alternative taxable income, adjusted gross income may also be reduced by a specially computed alternative tax net operating loss deduction. [11]

The alternative tax net operating loss deduction is the same as the "regular" net operating loss deduction modified in the following manner. In the case of a year after December 31, 1982, the net operating loss must be reduced by the amount of tax preference items and by taking into account only those itemized deductions which qualify as alternative tax itemized deductions as described above.

Once these deductions have been made, the taxpayer must then add the tax preferences for the year to this amount. The Code specifically lists the following tax preferences subject to inclusion in the alternative minimum taxable income. The first preference item to be included is the dividend exclusion. This is the amount of dividends excluded from the taxpayers gross income for the year. This is the $100 dividend exclusion. [12]

The second preference item is the excess of the accelerated cost recovery deduction taken on 15 (or 18) year real property over the amount taken under the straight line method. [13] Also included is the excess depreciation allowed on section 1250 real property, if the taxpayer used some other method of rapid depreciation in effect prior to ACRS, over the amount that would have been allowed following the straight line method. [14]

If the taxpayer's real property is not fully depreciated, the amount by which the accelerated depreciation allowance exceeds the straight line amount could be quite substantial. This excess adds to the amount of tax preference items included in determining the alternative minimum taxable income. Upon the sale of the asset, the "recapture" of this excess could result in

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[11] I.R.C. Sec. 55(e)(5)(A)
[12] $200 for joint filers
[13] I.R.C. Sec. 57(a)(12)(B)
[14] I.R.C. Sec. 57(a)(2)

the imposition of a significant alternative minimum tax burden.

Other preference items include accelerated cost recovery deductions on leased personal property, accelerated depreciation on personal property subject to a lease, amortization of certain pollution control facilities, mining exploration costs, circulation and research and experimental expenditures, reserves for bad debts, and the excess of percentage depletion over cost basis.[15] Incentive stock options and intangible drilling costs are two additional tax preference items that must be added to determine the alternative minimum taxable income. [16]

Of primary concern to the agriculturalist, in addition to the accelerated cost recovery items, is the inclusion of the 60% capital gain deduction as a tax preference item in computing alternative minimum taxable income. This is the item that results in a major tax burden for the farmer who attempts to alleviate his debt crises through asset liquidation. When computing his regular tax liability, the farmer was able to deduct 60% of the gain from the sale of his capital assets. This amount must now, however, be included in computing his alternative minimum taxable income.

Most tax preference items are also previously used deductions which tend to generate cash out of which to pay the alternative minimum tax. However, the income from these deductions was, for the most part, generated in past years and has long since been disposed of. For the farmer who wishes to liquidate assets and who has no ordinary income whatsoever, the tax burden can be overwhelming. This burden can be so great at times that the farmer finds himself "trapped" into holding assets because he cannot afford the tax liability associated with liquidation. However, a forced liquidation, one where the farmer may have little or no control over the timing of the sale, can lead to a substantial and unavoidable alternative minimum tax burden. In addition, the abandoning of assets from a bankruptcy proceeding followed by a forced liquidation can lead to substantial alternative minimum tax liability that must be paid by the individual.

The following is an example of how a farmers tax liability can be increased dramatically when he liquidates assets with no other source of income.

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[15] I.R.C. Secs. 57(a)(12)(A); 57(a)(3); 57(a)(4); 57(a)(5); 57(a)(6); 57(a)(7); 57(a)(9)(A)

[16] I.R.C. Secs. 57(a)(10)
57(a)(11)

EXAMPLE

This example relates to a farmer who is liquidating a 200 acre farm with a basis of $100,000 for a sale price of $200,000. This results in $100,000 of capital gain, 40% of which is included in adjusted gross income. Ordinary income equals zero. The example also relates to a married couple filing jointly with two dependents. For simplicity sake, we will assume that the capital gain deduction is the only tax preference item and that there are no alternative minimum tax itemized deductions.

REGULAR TAX:

AGI		40,000
Less:		
Personal Exemptions	4,000	
Itemized Deductions	- 0 -	
Taxable Income		36,000
Regular Tax		**6,546**

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ALTERNATIVE MINIMUM TAX:

AGI		40,000
Less:		
Alt. Min. Tax		
Itemized Deductions	- 0 -	
Plus Tax Preferences:		
Capital Gains Deduction . . .	60,000	
Alt. Min. Taxable Income		100,000
Less:		
Exemption	40,000	
Total Subject to Alt. Min. Tax		60,000
Alt. Min. Tax (20%)		12,000

Net Result: Taxpayer pays "regular tax" of $6546 and alternative minimum tax of $5,454.

As can be seen from even this simple example, liquidating assets can lead to a substantial tax burden. In many cases the amount that must be liquidated to bring the farmer back to a position of relative stability is much greater than the amount in the example. Correspondingly, the resulting tax burden is much greater. When the farmer is not in bankruptcy, this tax bill stays with him "forever", or until paid. Often, farmers that liquidate assets to try and reduce their debt burdens are also faced with serious cash flow shortages. As a result, they are unable to pay such a substantial tax assessment. This then "traps" the farmer into carrying his assets and the associated debts. Forced liquidations can also result in this substantial alternative minimum tax burden for the farmer, a burden he has no alternative but to assume.

However, maintaining this status quo will only mean added cost incurred by creditors due to the high levels of non-performing loans and bad debt losses. This in turn will work to accumulate interest bills on the debt and interest will then be charged against interest. One result of this will be to maintain interst rates at extremely high levels for farmers for an even longer period of time. More importantly, it will force more family farms out of business unnecessarily. This "catch-22" is one the agricultural economy should not be faced with in this period of economic weakness.

The intent of Congress when it created the alternative minimum tax was to deter persons in higher tax brackets from trying to convert a large portion of their income into capital assets so as to qualify for the preferred capital gains treatment. Clearly, these situations that Congress intended to discourage are exactly the opposite of the situations involving farmers who need to liquidate existing capital assets because of financial stress. Thus, maintaining this economic disincentive for farmers in no way furthers the intent of Congress.

In many cases, asset liquidation, either total or partial, would be beneficial to all aspects of the agricultural economy. The barrier created by the alternative minimum tax should be lessened or removed completely in order to facilitate this liquidation which would, in turn, lighten the debt load of farmers. This lightening of the debt load would provide an element of relief at a time when it is needed the most.

PLANNING OPPORTUNITIES

A key to facilitating asset liquidation and debt reduction is the minimization of the resulting tax burden. There are several strategies the farmer can employ that can help to minimize this impact while, at the same time, lightening the debt load through liquidation. Causing income and deductions relating to tax preference items to be placed into a year when the "regular" tax is expected to be small is a key to controlling and minimizing the burden of the alternative minimum tax. Causing the regular taxable income to be lowered by incurring deductible expenses or deferring sales is one method of lowering the alternative minimum tax.

Another method by which to minimize the impact of asset liquidation and the resulting tax burden is to consumate the sale on an installment basis. 17 Using the installment method can spread the receipt of proceeds over several years. Remember that for joint filers the first $40,000 of alternative minimum taxable income isn't taxed under the 20% rate structure. Therefore, if the proceeds from the sales can be spread out of a period of years and the farmer annually can take only as much of the 60% capital gains exemption to fit within this amount, then the impact of the alternative minimum tax is minimized or eliminated entirely.

It is also possible for a farmer to both reduce his alternative minimum taxable income and freeze the sale price of his assets at the same time. A contract sale can lock-in the current price of a non-fungible asset in the current year. For example, the farmer could conclude a sale of an asset in year one with the transfer of the asset and the sale proceeds occurring in some later year. If the farmer is on a cash reporting basis, he can delay the receipt of any resulting gain until a year when his adjusted gross income may be able to be lowered.

A taxpayer could also avoid the tax by making gifts of capital assets to other family members prior to liquidation. This would spread the taxable income among several taxpayers who may be able to shelter this amount under the exemption allowance. The goal of all of these methods should be to maintain the taxpayers capital gains deduction preference item at or below the exemption level or to lower the adjusted gross income level if the alternative minimum tax is inevitable.

The alternative minimum tax should also be considered during a bankruptcy proceeding. Often, arrangement are made whereby certain assets are abandoned from the bankruptcy proceeding to be disposed of privately between debtor and creditor. When this happens, all resulting capital gains are subject to the alternative minimum tax. This tax liability is separate from the bankruptcy proceeding and is the sole responsibility of the bankrupt debtor. Therefore, when negotiating the terms of a bankruptcy proceeding, the debtor should strive to maintain all assets within the estate to eliminate the imposition of the

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I.R.C. Sec. 453

alternative minimum tax on him.

LEGISLATIVE CHANGES

Another possibility to facilitate asset liquidation during times of economic stress would be a change in the current tax laws. These changes would reduce or eliminate the tax impediments foreseen by many farmers when contemplating asset liquidation.

Currently proposed and pending in the Senate Finance Committee in Washington is a bill known as the Grassley Amendment. This bill seeks to redefine insolvency so as to exclude persons from the alternative minimum tax if they qualify as insolvent under a new definition. Currently, a taxpayer must be 100% insolvent to qualify for any relief under the Federal Tax Code. [18] The Grassley Amendment defines insolvency at a 70% debt to asset ratio. Though "financial stress" for farmers is being defined by the USDA to be a 40% debt to asset ratio, this proposal would reduce the tax impediment of liquidating for a large number of severely stressed farmers. [19]

The State of Iowa has an alternative minimum tax similar to that of the federal government. Recently passed by the Iowa Legislature was Senate File 24 which is designed to protect persons who liquidate assets out of necessity from paying a substantial alternative minimum tax. The new law states that when computing tax preference items for the taxable year, any gain from the transfer of property to a creditor in cancellation of a debt or from the sale of property in foreclosure shall not be taken into account if the taxpayers liabilities exceed assets and the taxpayers net worth at the end of the taxable year is less than $100,000.

This bill was designed to reduce the tax barriers impeding the liquidation of assets. It appears, however, that many farmers who are not insolvent will not be able to take advantage of this exemption. Those farmers considered to be financially stressed with a debt asset ratio of less than 100% are still unable to avoid the payment of the state alternative minimum tax. It appears that while the bill has good intentions, it does not go far enough to remove the tax impediments incurred upon asset liquidation.

There are three major obstacles to changes in the tax laws which are designed to encourage asset liquidation. These

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[18] I.R.C. Sec. 108

[19] Source: Economic Indicators, State Income and Balance Sheet Statistics, USDA, 1983.

impediments include the loss of revenue for the federal government, the standard qualification criteria, and the need for equitable treatment of all taxpayers. In the case of some farmers, eliminating the alternative minimum tax at some financial threshold would be a complete foregiveness of tax obligations upon asset liquidation. This would result in a reduction in revenues for the federal government. However, if the current tax laws continue to discourage farmers from liquidating assets and, as a result they operate at a loss, tax revenues are also lost.

If tax laws were changed to remove some tax impediments to asset liquidation, eligibility criteria would have to be established. Establishing these criteria would be difficult indeed. The first step would be to define financial stress. The Grassley Amendment compromises at a debt to asset ratio of 70%. Also necessary would be to distinquish between sales in the ordinary course of business, those being fully subject to the alternative minimum tax, and those sales designed to liquidate assets. Protection against exploitive use of the new exemption would be a primary concern.

The third issue confronted in proposing changes in the tax code involves the equitable treatment of all taxpayers. Designing a tax program to aid only a small segment of the economy is not a new concept. Other sectors of the economy would, as they do now, demand special treatment. In the Grassley Amendment, there is no need for reference just to financially stressed farmers; the provisions of that legislation can be applied to any liquidation resulting from financial stress.

It appears that any changes in the tax laws could help to prevent a financially stressed taxpayer from being trapped into holding assets. It is possible to design laws to facilitate and reduce the tax impact of asset liquidation. This is exactly the goal of the Grassley Amendment. However, designing an effective modification that is acceptable to all economic sectors will be difficult.

CONCLUSION

It is clear to anyone involved in agriculture that the economic recovery so long awaited has yet to impact the farm economy. Thousands of farms nationwide are suffering from stress so severe they will require some form of debt or asset restructuring to survive the current crises. Asset liquidation is one alternative to employ to help alleviate the heavy debt load these farms are struggling under.

However, liquidating assets frequently triggers the alternative minimum tax. This resulting tax burden often comes at a time when the farm has little or no cash flow with which to pay the bill. Steps need to be taken by the farmer to eliminate or reduce the alternative minimum tax while at the same time liquidating assets to reduce the heavy debt load. Reduction of income, increasing deductible expenses, installment sales, contract sales of non-fungible assets, and gifting of assets to family members to spread the capital gain over several taxpayers are methods whereby the 60% capital gains preference item can be reduced to avoid the alternative minimum tax. Changes in the tax laws are also pending which may help the farmer liquidate assets and avoid burdensome tax liabilities.